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Analysts Concerned About Upgrades En Masse in Muni Ratings Scale Shift

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By Caitlin Devitt

CHICAGO - The wave of upgrades on the horizon as rating agencies shift to a new global rating scale comes as governments face some of their toughest fiscal challenges in decades, and could sow uncertainty across the municipal market, investor analysts said at a recent roundtable here.

"I have strong reservations about upgrades en masse," said Richard Ciccarone, managing director and chief research officer for McDonnell Investment Management LLC, adding that upgrades have been outpacing downgrades for several years. "If economic conditions worsen, will there be a rush to downgrade?"

So far this year, rating upgrades have outpaced downgrades 13.2 to one, compared to five to one throughout 2007.

"These will not be true upgrades," said Paul Brennan, a vice president portfolio manager at Nuveen Investments. "These are simply recalibrations. But the credit fundamentals will not change. And the credit fundamentals are deteriorating."

The talk, "Global Ratings Scale: Boom or Bust for the Buyside?" was hosted by the Chicago Municipal Analysts Society at Nuveen's downtown Chicago offices.

Implementation of a unified global rating scale for both municipal and corporate bonds comes as politicians and regulators charge that rating agencies rate municipal debt too low compared to corporate debt, particularly considering municipal issuers' generally low default rates.

In response, Moody's Investors Service has said it would introduce a new unified scale in October, while Standard & Poor's has been busy upgrading its municipal credits all year. Fitch Ratings has said it expects the change will boost to 86% from 58% the number of state and local general obligation credits that will be rated in the AA or AAA categories.

The analysts warned that the wave of upgrades could mean reduced fiscal vigilance - and false confidence - on the part of government officials as well as retail investors..

"I think the current credit scale forces fiscal officials to have better discipline to try to get better ratings," Brennan said. The new scale "may reduce the desire to maintain fiscal prudence, and may increase defaults in the future. Also it could mean less transparency, and investors can't get enough information on issuers."

Under the new global scale, rating agencies are expected to use the probability of default as a more important criteria than is currently taken into account. But that criteria could prove misleading, analysts said. Part of the reason is because investors are generally more concerned with timely payments, which could become increasingly difficult for issuers as liquidity tightens across the market.

In addition, the probability of default by higher-rated credits has in the past been badly misjudged.

Ciccarone cited a 1964 study by George Hempel on municipal defaults during the Great Depression showing that as of 1929, Moody's had Aa or Aaa ratings on 98% of cities with populations of more than 30,000. But defaults spiked in the years that followed, and among municipalities with populations of more than 10,000 reached 30% of Aa-rated cities and 48% of Aaa-rated cities throughout the depression.

"Those are big numbers," Ciccarone said, adding that most issuers did not begin to default for a few years after the 1929 market crash - showing how government fiscal activity often lags behind market activity.

But some investor analysts said they would continue to rely on their own research even as rating agencies implement the new scale.

"Puerto Rico - even if it gets upgraded, we're still not buying it," said A.G. Anglum, vice president for municipal research/trading at Harris Bank NA. "Even if we think the default risk is low, the headline risk is too high for our clients."

However, Anglum added that Harris' dealers are "very bullish" on the new global scale. "They're busy buying cheap A credits in anticipation of the upgrades," he said.
